84-SBE-069

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PENN GENERAL AGENCIES OF CALIFORNIA, INC.)

Appearances:

For Appellant: Lawrence Hirota
Vice President and Controller

Por Respondent: Charlotte A. Meisel
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Penn General Agencies of California, Inc., against proposed assessments of additional franchise tax in the amounts of $19,433 and $1,615 for the income years 1976 and 1978, respectively.

Two issues are presented in this appeal. The first issue is whether appellant has established its entitlement to a $125,000 deduction of miscellaneous business expenses for the income year 1976. The second issue is whether appellant has shown that respondent's computation of additions to appellant's bad debt reserve was unreasonable or arbitrary and results in an abuse of its discretion.

Appellant is a California corporation which reports its income on an accrual basis. In the performance of its business function, appellant writes insurance policies for clients on behalf of various insurance companies, collects premiums from clients, and pays the premiums to the insurance companies, less commissions. For clients who arrange to pay premiums in installments, appellant records each transaction as an account receivable from the client and an account payable for the same amount, less commissions, to the insurance company.

In 1976 the parent company of appellant, Penn General Agencies, Inc., reviewed appellant's books and records for the purpose of adopting a new accounting system. This review disclosed that the accounts payable to insurance companies exceeded the accounts receivable from clients by approximately $125,000. Penn General Agencies, Inc., was unable to find the cause of this discrepancy; however, the controller for appellant in July of 1980 surmised that the imbalance was the result of five errors in bookkeeping. These alleged errors were: (1) the overstatement of commission income; (2) payments made to insurance companies without subsequent billings to insureds; (3) double payments to insurance companies; (4) erroneous credits to insureds; and (5) incorrect recording of premium finance credits.

Appellant claimed a $158,936 deduction for miscellaneous expenses on its return for the income year 1976, which includes the $125,000 amount discussed above. Respondent disallowed $125,000 of this claimed miscellaneous expense deduction and issued a Notice of Additional Tax Proposed to be Assessed on April 17, 1981. Respondent concluded that appellant did not provide evidence to support its position that any of the alleged errors did occur, or that if any of the errors did occur, any deductible expense resulted.

Appellant contends that the expenses should be allowed because each expense is supported by a cancelled check and an entry in the general ledger. While appellant

cannot specifically document the year in which the expenses occurred, it contends that normally all payables will clear in a ninety-day period and that the bulk of the expenses are attributable to the year 1976.

On its return for the income year 1976, appellant, in addition to the above mentioned miscellaneous expenses, deducted $232,745 for bad debts. On its return for the income year 1978, appellant deducted $47,909 for bad debts.

When appellant incorporated in 1970, it began using the reserve method of reporting bad debts. In 1973 appellant changed to the specific charge-off method of reporting, without first obtaining the approval of respondent. For the income years 1976 and 1978, appellant used a hybrid specific charge-off method of accounting for its bad debts. Accounts that were in litigation as well as slow-paying accounts were treated as bad debts.

Respondent found appellant's deductions for bad debts to be unreasonable for the years 1976 and 1978. Respondent, using a six-year moving average formula as defined in Black Motor Co., 41 B.T.A. 300 (1940), affd., 125 F.2d 977 (6th Cir. 1942), determined that the allowable additions to appellant's reserve for bad debts were $11,032 for the income year 1976, and $26,719 for the income year 1978. Respondent disallowed appellants claimed bad debt deductions in excess of these amounts. Respondent also revised appellant's deductions for bad debts for the income years 1977 and 1979, but due to substantial losses reported by appellant for those years, the adjustments had no tax effect. Appellant filed a timely protest contending that prior to mid-1975 appellant had clients with well-established payment records. After mid-1975 the corporation began a more aggressive marketing program and began dealing with clients who had poor payment practices. Appellant contends that no collections were ever made on the accounts written off and that respondent is acting unreasonably in refusing to recognize these accounts.

Section 24343 of the Revenue and Taxation Code provides for a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. All deductions, however, are a matter of legislative grace, and the one claiming the deduction must bear the burden of proving entitlement to the deduction claimed. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).)

Appellant has established the existence of a $125,000 imbalance in its books and has shown that this imbalance was discovered in 1976. It has not been able, however, to identify (1) the accounts which were involved in the imbalance, (2) the deductible nature of the items causing the imbalance, or (3) the particular year in which any such item was properly deductible. Since appellant has not shown that it is entitled to a deduction in 1976 for any part of the imbalance, we must conclude that respondent's disallowance of $125,000 in miscellaneous expenses was proper.

Section 24348 of the Revenue and Taxation Code allows as a deduction debts which become worthless within the income year, or, in the discretion of respondent, a reasonable addition to a reserve for bad debts. Appellant was incorporated in 1970 and used the reserve method of reporting its bad debts until 1973 when, without permission from respondent, it changed to the specific charge-off method. During the years at issue, respondent's regulations provided that a taxpayer who properly selected one of the two methods was required to use that method for all subsequent income years unless respondent granted permission to use the other method. (Former Cal. Admin. Code, tit. 18, reg. 24348(d), subd. (2)(A), repealer filed Sept. 3, 1982 (Register 82, No. 37).) Therefore, appellant, having-adopted the reserve method for deducting bad debts, could not change to the specific charge-off method without the express consent of respondent. (Appeal of Lytton Savings and Loan Association, Cal. St. Bd. of Equal., Aug. 7, 1969; see Rogan v. Commercial Discount Co., 149 F.2d 585 (9th Cir. 1945).) No consent by respondent was ever given; thus, appellant, by its own election, is limited during the years at issue to the reserve method of deducting bad debts.

By choosing to use the reserve method, appellant has subjected itself to the reasonable discre-tion of respondent. (Union National Bank & Trust Co. of Elgin, 26 T.C. 537 (1956); see Rev. & Tax. Code, § 24348, subd. (a).) Because of this express statutory discretion, the burden of proof which appellant must carry to overcome such a determination by respondent is greater than the usual burden. Appellant must do more than demonstrate that its additions to the reserve were reasonable. Appellant must also show that respondent's actions in disallowing the additions were arbitrary and amounted to an abuse of discretion. (Appeal of Vaughn F. and Betty F. Fisher, Cal. St. Bd. of Equal., Jan. 7, 1975; Roanoke Vending Exchange, Inc., 40 T.C. 735 (1963).)

Respondent utilized the six-year moving average formula which was set out by the court in Black Motor Company, supra, and approved by the United States Supreme Court in Thor Power Tool Co. v. Commissioner, 439 U.S. 522 [58 L.Ed.2d 785] (1979). This formula applies the taxpayer's own experiences with losses in prior years and establishes a percentage level for the reserve in determining the need for and amount of a current addition. Appellant has not shown that respondent's use of the six-year moving average formula was arbitrary or amounted to an abuse of discretion. Consequently, we must conclude that respondent's actions. were proper.

We note that appellant has alleged that a $40,288 debt owed by Westsail Corporation became worthless in 1976 and that a deduction for it should be permitted in that year. Even if the specific charge-off method was proper, which it is not, no deduction could be allowed as appellant has not established that this debt became worthless in 1976. (Rev. & Tax. Code, § 24348.) The evidence available indicates that Westsail Corporation did not file in bankruptcy until 1977 and that as late as 1979 appellant made attempts to collect on this account.

For the reasons stated above, we must sustain respondent's action.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Penn General Agencies of California, Inc., against proposed assessments of additional franchise tax in the amounts of $19,433 and $1,615 for the income years 1976 and 1978, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 8th day of May , 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins , Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis , Member

William 14. Bennett , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9